JUDGMENT OF THE COURT (Second Chamber)

8 June 2000 *

In Case C-98/98,

REFERENCE to the Court under Article 177 of the EC Treaty (now Article 234 EC) by the High Court of Justice of England and Wales (Queen's Bench Division) for a preliminary ruling in the proceedings pending before that court between

Commissioners of Customs & Excise

and

Midland Bank plc

on the interpretation of Article 2 of the First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (OJ, English Special Edition 1967, p. 14) and Article 17(2), (3) and (5) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (OJ 1977 L 145, p. 1),

* Language of the case: English.

THE COURT (Second Chamber),

composed of: R. Schintgen, President of the Chamber, G. Hirsch (Rapporteur) and H. Ragnemalm, Judges,

Advocate General: A. Saggio,
Registrar: L. Hewlett, Administrator,

after considering the written observations submitted on behalf of:

— Midland Bank plc, by R. Cordara QC and P.A. McGrath, Barrister, instructed by P. Kelly, solicitor,

— the United Kingdom Government, by J.E. Collins, Assistant Treasury Solicitor, acting as Agent, assisted by K.P.E. Lasok QC and M. Hall, Barrister,

— the Commission of the European Communities, by E. Traversa, of its Legal Service, and F. Riddy, a national official on secondment to the Commission's Legal Service, acting as Agents,

having regard to the Report for the Hearing,

after hearing the oral observations of Midland Bank plc, the United Kingdom Government and the Commission at the hearing on 3 June 1999,

after hearing the Opinion of the Advocate General at the sitting on 30 September 1999,

gives the following

Judgment

1 By order of 31 July 1997, received at the Court on 3 April 1998, the High Court of Justice of England and Wales (Queen's Bench Division) referred to the Court for a preliminary ruling under Article 177 of the EC Treaty (now Article 234 EC) three questions on the interpretation of Article 2 of the First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (OJ, English Special Edition 1967, p. 14, hereinafter 'the First Directive') and Article 17(2), (3) and (5) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (OJ 1977 L 145, p. 1).

2 Those questions were raised in the context of a dispute between the Midland Bank plc ('the Midland') and the Commissioners of Customs & Excise ('the Commissioners'), who have jurisdiction in matters relating to the levying of value added tax ('VAT') in the United Kingdom, concerning the deduction of the VAT which it had paid in respect of legal services.

Community provisions

3 The second paragraph of Article 2 of the First Directive provides:

'On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components'.

4 Directive 77/388 was amended by Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers (OJ 1991 L 376, p. 1, hereinafter 'the Sixth Directive').

5 According to Article 17 of the Sixth Directive, entitled 'Origin and scope of the right to deduct':

'1. The right to deduct shall arise at the time when the deductible tax becomes chargeable.

2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:

(a) value added tax due or paid in respect of goods or services supplied or to be supplied to him by another taxable person liable for the tax within the territory of the country;

...

3. Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:

...

(c) any of the transactions exempt under Article 13B(a) and (d) (1) to (5), when the customer is established outside the Community...

...

5. As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not

deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions'.

...

Article 17(5) also contains provisions concerning the determination of the proportional deduction, the choice from among several methods for determining such proportion being left to the Member States.

Article 13B(d) of the Sixth Directive, referred to in Article 17(3)(c), exempts a number of transactions usually carried out by banks.

National provisions

6 The United Kingdom implemented Article 17(3)(c) of the Sixth Directive by treating the transactions referred to therein as zero-rated, while deeming them to be theoretically taxable, so that although the right to deduct exists no tax is actually charged.

7 As for implementation of Article 17(5) of the same directive, relating to the case of taxable persons who use goods and services in order to carry out both taxable and exempt transactions, United Kingdom legislation provides for various formulae for calculating the amount of the input VAT that can be deducted.

Facts in the main proceedings and questions referred for a preliminary ruling

8 The Midland is the representative member of a group of companies taken together for the purposes of VAT, which includes the London merchant bank Samuel Montagu & Co. Ltd (hereinafter 'Samuel Montagu'), which supplies services some of which are taxed and some of which are exempt.

9 In 1987, Samuel Montagu acted as merchant bank for Quadrex Holdings Inc. (hereinafter 'Quadrex'), a corporation registered in Delaware, United States of America. Quadrex wanted to take over Mercantile House Holding Ltd (hereinafter 'Mercantile'), a company quoted on the London Stock Exchange. However, British and Commonwealth Holding plc (hereinafter 'B & C') was also interested in taking over Mercantile. In August 1987, Quadrex and B & C entered into an agreement under which B & C would buy Mercantile, and then sell the latter's wholesale broking division to Quadrex. B & C subsequently took over Mercantile. However, Quadrex was not able to purchase the abovementioned division from B & C because it lacked the funds.

10 A series of legal proceedings was then started in 1988 before the national courts. B & C sued Quadrex for damages for breach of contract. In the context of that dispute, Quadrex claimed that Samuel Montagu should indemnify it for any damages awarded. B & C also sued Samuel Montagu for damages for the alleged negligent misrepresentation by a Samuel Montagu director as to Quadrex's finances. The claim was finally settled out of court at the end of 1994.

11 In connection with the agreement between Quadrex and B & C, the solicitors Clifford Chance supplied legal services to Samuel Montagu and were entrusted with all the work connected with the disputes referred to in the preceding

paragraph and the litigation arising from it. Clifford Chance invoiced Samuel Montagu for its fees for 1988 to 1995, and it is the VAT charged on those fees which is in issue in the main proceedings.

12 The Midland claimed that the legal services supplied by the solicitors were entirely attributable to the supply of financial services by Samuel Montagu to Quadrex, which was a supply in respect of which VAT was deductible in accordance with Article 17(3)(c) of the Sixth Directive. Accordingly, the Midland claimed the right to deduct the entire amount of VAT paid on the legal fees invoiced by the aforementioned solicitors.

13 The Commissioners, for their part, took the view that Samuel Montagu had not used the legal services in issue solely for the purpose of carrying out transactions in respect of which VAT is deductible. They therefore concluded that the Midland was entitled to deduct only part of the VAT.

14 The Midland appealed to the VAT and Duties Tribunal, claiming in particular that the legal services provided by the lawyers related as a whole to the supply of services made by Samuel Montagu to Quadrex. By decision of 15 May 1996, that tribunal allowed Midland's appeal, holding that the input VAT paid in respect of the solicitors' invoices was deductible in its entirety.

15 The Commissioners appealed against that decision to the High Court of Justice. They argued that the legal services were obtained to defend Samuel Montagu against claims that it was liable in damages as a result of acts attributable to it which were performed whilst it was making the supply to Quadrex. The legal services were thus also attributable to Samuel Montagu's business generally. Since that business consisted of a mixture of supplies in respect of which the right of

deduction was available and supplies in respect of which it was not, there should have been an apportionment of the input tax in accordance with Article 17(5) of the Sixth Directive.

16 In those circumstances, taking the view that an interpretation of certain provisions of the First and Sixth Directives was necessary in order to resolve the dispute before it, the High Court stayed the proceedings and referred to the Court of Justice for a preliminary ruling the following three questions:

'On the proper interpretation of Council Directive 67/227/EEC of 11 April 1967, in particular Article 2, and Council Directive 77/388/EEC of 17 May 1977, in particular Article 17(2), (3) and (5), and having regard to the facts of the present case:

1. Is it necessary to establish a direct and immediate link between a particular input obtainable by a taxable person acting as such and a particular transaction or transactions made by that person in order to

   (a) establish the existence of an entitlement to deduct tax charged in respect of the input; and

   (b) determine the extent of that entitlement?

2. If the answer to (1)(a) or (b) is in the affirmative, what is the nature of the direct and immediate link and, in particular, in the case of a taxable person making both transactions in respect of which VAT is deductible and transactions in respect of which it is not:

   (a) is the test for determining the amount of input tax that is deductible any different as between Article 17(2), (3) and (5) (and, if so, in which respects is it different); and

   (b) is such a person entitled to deduct all the input tax charged in respect of an input on the ground that the input was utilised as a consequence of making a transaction falling within Articles 17(2) or (3), in particular Article 17(3)(c)?

3. If the answer to 1(a) or (b) is in the negative:

   (a) what is the link that has to be established; and

   (b) in the case of a taxable person making both transactions in respect of which VAT is deductible and transactions in respect of which it is not:

      (i) is the test for determining the amount of input tax that is deductible any different as between Article 17(2), (3) and (5) (and, if so, in which respects is it different); and

(ii) s such a person entitled to deduct all the input tax charged in respect of an input on the ground that the input was utilised as a consequence of making a transaction falling within Article 17(3)(c)?'

The first question

17 By its first question, the national court is asking, in essence, whether Article 2 of the First Directive and Article 17(2), (3) and (5) of the Sixth Council Directive must be interpreted as meaning that the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement.

18 The Midland, the United Kingdom Government and the Commission consider that the answer to that question should be in the affirmative.

19 As a preliminary point, it must be recalled that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities, provided that such activities are themselves, in principle, subject to VAT (see, to this effect, Case 268/83 *Rompelman* v *Minister van Financiën* [1985] ECR 655, paragraph 19, Case C-37/95 *Ghent Coal Terminal* [1998] ECR I-1, paragraph 15, and Joined Cases C-110/98 to C-147/98 *Gabalfrisa and Others* [2000] ECR I-1577, paragraph 44). However, by way of exception, a taxable person who, like Samuel Montagu, carries out exempt transactions pursuant to Article 13B(d)(1) to (5) of the Sixth Directive in the

circumstances provided for in Article 17(3)(c) is also entitled under that provision to deduct VAT to the extent that he has used input goods and services for the purpose of such exempt transactions.

20 As the Court has held, Article 17(5) of the Sixth Directive, in the light of which Article 17(2) must be interpreted, lays down the rules applicable to the right to deduct VAT where the VAT relates to input transactions used by the taxable person 'both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible'. The use in that provision of the words 'for transactions' shows that to give the right to deduct under paragraph 2, the goods or services acquired must have a direct and immediate link with the output transactions giving rise to the right to deduct and that the ultimate aim pursued by the taxable person is irrelevant in this respect (see Case C-4/94 *BLP Group* [1995] ECR I-983, paragraphs 18 and 19).

21 That interpretation is confirmed by Article 2 of the First Directive, which states that only the amount of VAT borne directly by the various cost components of a taxable transaction may be deducted.

22 However, as the Court has also held, entitlement to deduct, once it has arisen, is retained even if the economic activity envisaged does not give rise to taxed transactions or the taxable person has been unable to use the goods or services which gave rise to a deduction in the context of taxable transactions by reason of circumstances beyond his control (Case C-110/94 *INZO* v *Belgian State* [1996] ECR I-857, paragraphs 20 and 21; *Ghent Coal Terminal*, cited above, paragraph 20, and C-396/98 *Schloßstraße* [2000] ECR I-4279, paragraph 42).

23 It is clear from that case-law that, as an exception and in specific circumstances, the right to deduct exists even if a direct and immediate link between a particular

input transaction and an output transaction or transactions giving rise to the right to deduct cannot be established.

24 The answer to the first question must therefore be that Article 2 of the First Directive and Article 17(2), (3) and (5) of the Sixth Council Directive must be interpreted as meaning that, in principle, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement.

The second question

25 In so far as the national court seeks, in the first part of the second question, clarification of the nature of the 'direct and immediate link', the Midland, the United Kingdom Government and the Commission rightly agree that it would not be realistic to attempt to be more specific in that regard. In view of the diversity of commercial and professional transactions, it is impossible to give a more appropriate reply as to the method of determining in every case the necessary relationship which must exist between the input and output transactions in order for input VAT to become deductible. It is for the national courts to apply the 'direct and immediate link' test to the facts of each case before them and to take account of all the circumstances surrounding the transactions at issue.

26 So far as concerns Question 2(a), the Midland, the United Kingdom Government and the Commission also agree that a taxable person who makes transactions in respect of which VAT is deductible and transactions in respect of which it is not may nevertheless deduct the VAT charged on the goods or services acquired by him, provided that such goods or services have a direct and immediate link with the output transactions in respect of which VAT is deductible, without it being necessary to take into account Article 17(2), (3) or (5) of the Sixth Directive. If

that were not so, essentially identical facts would lead to different outcomes according to the provision governing the transactions carried out by the taxable person.

27 By Question 2(b), the national court is essentially asking whether a taxable person making both transactions in respect of which VAT is deductible and transactions in respect of which it is not may deduct in its entirety the input VAT charged on goods or services, even where such goods or services have been utilised not for the purpose of carrying out a deductible transaction but in the context of activities which are no more than the consequence of making such a transaction.

28 The Midland, the United Kingdom Government and the Commission are of the view that, where a consequential relationship exists between the input and output transactions, the test for determining whether there is a right to deduct is also whether there exists a direct and immediate link between those two transactions. In that context, the Midland points out that the aforementioned link requires an objective relationship between the input and the output transactions such that the input can be said to be part of the cost to the trader of making the output, irrespective of whether the input be preparatory to the output or be a consequence thereof. On the other hand, the United Kingdom Government maintains that the legal services supplied to a taxable person making both taxable and exempt transactions, services which are the consequence of a claim for damages against that person for making transactions in respect of which tax is payable, do not have such a direct and immediate link with them. On account of their nature, those legal services should necessarily be considered to be part of the general costs so that VAT is deductible only in part.

29 It should be borne in mind that, according to the fundamental principle which underlies the VAT system, and which follows from Article 2 of the First and Sixth Directives, VAT applies to each transaction by way of production or distribution

after deduction of the VAT directly borne by the various cost components (see, to this effect, Case C-62/93 *BP Supergas* [1995] ECR I-1883, paragraph 16).

30 It follows from that principle as well as from the rule enshrined in paragraph 19 of the judgment in *BLP Group*, cited above, according to which, in order to give rise to the right to deduct, the goods or services acquired must have a direct and immediate link with the taxable transactions, that the right to deduct the VAT charged on such goods or services presupposes that the expenditure incurred in obtaining them was part of the cost components of the taxable transactions. Such expenditure must therefore be part of the costs of the output transactions which utilise the goods and services acquired. That is why those cost components must generally have arisen before the taxable person carried out the taxable transactions to which they relate.

31 It follows that, contrary to what the Midland claims, there is in general no direct and immediate link in the sense intended in the *BLP Group* judgment, cited above, between an output transaction and services used by a taxable person as a consequence of and following completion of the said transaction. Although the expenditure incurred in order to obtain the aforementioned services is the consequence of the output transaction, the fact remains that it is not generally part of the cost components of the output transaction, which Article 2 of the First Directive none the less requires. Such services do not therefore have any direct and immediate link with the output transaction. On the other hand, the costs of those services are part of the taxable person's general costs and are, as such, components of the price of an undertaking's products. Such services therefore do have a direct and immediate link with the taxable person's business as a whole, so that the right to deduct VAT falls within Article 17(5) of the Sixth Directive and the VAT is, according to that provision, deductible only in part.

32 It could only be otherwise if the taxable person were able to prove that, exceptionally, the costs relating to the goods or services which he has utilised as a

consequence of making a deductible transaction are part of the cost components of that transaction.

33 The answer to the second question must therefore be that it is for the national court to apply the 'direct and immediate link' test to the facts of each case before it. A taxable person who makes transactions in respect of which VAT is deductible and transactions in respect of which it is not may deduct the VAT in respect of the goods or services acquired by him, provided that such goods or services have a direct and immediate link with the output transactions in respect of which VAT is deductible, without it being necessary to take into account Article 17(2), (3) or (5) of the Sixth Directive. However, such a taxable person cannot deduct in its entirety the VAT charged on input services where they have been utilised not for the purpose of carrying out a deductible transaction but in the context of activities which are no more than the consequence of making such a transaction, unless that person can show by means of objective evidence that the expenditure involved in the acquisition of such services is part of the various cost components of the output transaction.

The third question

34 In view of the answers to the first two questions, there is no need to reply to the third question.

Costs

35 The costs incurred by the United Kingdom Government and by the Commission, which have submitted observations to the Court, are not recoverable. Since these

proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court.

On those grounds,

THE COURT (Second Chamber),

in answer to the questions referred to it by the High Court of Justice of England and Wales (Queen's Bench Division) by order of 31 July 1997, hereby rules:

1. **Article 2 of the First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes and Article 17(2), (3) and (5) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment must be interpreted as meaning that, in principle, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input value added tax and in order to determine the extent of such entitlement.**

2. It is for the national court to apply the 'direct and immediate link' test to the facts of each case before it. A taxable person who makes transactions in respect of which value added tax is deductible and transactions in respect of which it is not may deduct the value added tax in respect of the goods or services acquired by him, provided that such goods or services have a direct and immediate link with the output transactions in respect of which value added tax is deductible, without it being necessary to take into account Article 17(2), (3) or (5) of the Sixth Directive 77/388. However, such a taxable person cannot deduct in its entirety the value added tax charged on input services where they have been utilised not for the purpose of carrying out a deductible transaction but in the context of activities which are no more than the consequence of making such a transaction, unless that person can show by means of objective evidence that the expenditure involved in the acquisition of such services is part of the various cost components of the output transaction.

Schintgen Hirsch Ragnemalm

Delivered in open court in Luxembourg on 8 June 2000.

R. Grass

Registrar

R. Schintgen

President of the Second Chamber